THE FEDERAL INCOME TAX CONCEPT OF CORPORATION INCOME

BY

CHARLES JOHN GAA

B. S., University of Illinois, 1932
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AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ACCOUNTANCY IN THE GRADUATE SCHOOL OF THE UNIVERSITY OF ILLINOIS, 1940

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THE FEDERAL INCOME TAX CONCEPT OF CORPORATION INCOME

An indirect, but heavy, burden of taxation is that of preparing tax and other reports for various governmental bodies. In order to eliminate the need for special tax records and computations, Federal Income Tax provisions should conform as closely as possible with good business and accounting procedure. Business and accounting methods which are not good should be changed and not forced into Federal Income Tax provisions.

It has been suggested frequently that some sort of Federal commission on accounting and tax matters be formed to coordinate the demands of the multitudinous governmental units with each other and with proper business and accounting provisions for income determination and accounting records. In order to be effective and truly useful, the committee would have to be chosen on a non-partisan, scientific basis, and would have to be composed of businessmen, lawyers, accountants, tax experts, and government administrators.

An ideal system of standards for income determination and allowable deviations therefrom could be constructed by such a committee. Care would have to be exercised not to make these standards too detailed or restrictive, because much of our difficulty with the Federal Income Tax has been caused by the inclusion of too many detailed procedures. The result has been that inconsistencies have arisen between the various Federal Income Tax provisions themselves and between such provisions and accounting and business procedures. Individual procedures would not need to be uniform but would be required merely to remain within the broad structure outlined.

Litigation which might arise out of income tax cases could be settled on a case basis, as is done in those cases brought under the jurisdiction of the Securities and Exchange Commission. Preliminary advisory opinions could be furnished a taxpayer regarding contemplated actions, in order to eliminate the objection that a very general law might be too vague and uncertain in its effects on the taxpayer's tax liability and conduct of his business.

In order that the work of such a committee may be carried on, it is necessary that there be constructed a system of standards for income determination and the acceptable deviations therefrom. A considerable amount of work has been done already to construct this fundamental base, but there is as yet no generally accepted system. Against such a system of standards must be compared the existing, practical accounting methods and the Federal Income Tax concept of income.

A comparison of the Federal Income Tax concept of income with a system of standards depends not only upon a determination of such standards but also upon the determination of the income tax concept of income. This thesis is an historical and theoretical study of detailed income tax provisions and a distillation of the Federal Income Tax concept of corporation income from them. This concept is based upon statutory provisions; Bureau of Internal Revenue regulations, opinions, and decisions; Board of Tax Appeals decisions; and court rulings.

The present unsettled status of the many competing ideas of standards and principles of income determination make it impossible to present one system which may be said to be generally accepted. Therefore, in order to analyze critically the Federal Income Tax provisions, it has been necessary to construct a tentative and private system of standards of income determination based on the author's concept of income.

Even after suitable standards for income determination have been set up and used, there still may be allowable divergences in Federal Income Tax provisions from such standards. In many cases, difficulties of measurement, need for objective proof, and cost and difficulty of administration may make it advisable to use other than the methods approved within the standards set. Certain social goals may be achieved by including special provisions therefor within the Federal Income Tax system. However, it may be that such goals can be achieved without disrupting the income tax system, by providing penalties and subsidies outside of the income tax system. Unfortunately, political expediency has caused, and probably will continue to cause, differences between tax and accounting methods for computing income.

The income tax provisions studied are those related to the Federal Acts passed since the adoption of the Sixteenth Amendment. The scope of the study includes the Federal Income Tax concept only as it applies to ordinary, domestic, business corporations. Income determination is the central theme of the thesis. No attempt has been made to examine administrative methods, general problems of taxation, justice in taxation, the rate structure, exemptions, surtaxes, undistributed profits taxes, penalties, reciprocity with other tax jurisdictions, or foreign exchange problems.

Accounting and Federal Income Tax provisions do not contain consistently any one concept of the proper entity for which income calculations are to be made.

The legal entity of a corporation is supported by the provisions which state that taxable income results to the recipient of a dividend upon its receipt, or when it is made available to the shareholder. It is upheld also by the taxation of intercorporate dividends.

The legal entity is recognized, but the wider economic entity is ignored by income tax provisions which forbid consolidated returns.

The legal entity is supported by the provisions which recognize gains or losses to a corporation upon transactions in its own reacquired shares. The rule now in force is that they are taxable if the transactions were entered into for profit and were the equivalent of transactions in shares of another corporation.

The provisions which include in the shareholder's income an amount resulting from the sale by the corporation to the shareholder of property substantially below its fair market value ignore the legal entity.

A satisfactory broad concept of income is: *the net increase of purchasing power from all sources, excluding additional investments and withdrawals.* This concept must be modified for accounting and tax purposes to take into consideration difficulties of measurement and the necessity for objectivity. A suitable concept of income for tax and accounting uses is: *the net realized increase of assets from all sources, measured in terms*

of money, between two points of time, excluding additional investments and withdrawals.

The analysis of the Federal Income Tax treatment of each of these elements of a satisfactory definition is given in the following discussion.

Net

The tax was intended to conform with the popular conception of income held at the time the tax was introduced in 1913, which concept probably was that of net income. All of the Acts from 1913 to 1938 have contained recognition that net income, computed by accounting methods, is to be determined and taxed. Unfortunately, it has also been provided that such determination is to be made subject to deviations considered necessary by Congress or the Commissioner. The statutes and the Supreme Court have held substantially that the tax is to be on gross income, reduced only by the things Congress may allow to be deducted.

Ordinary and necessary business expenses, repairs, rentals, traveling expenses, fees, compensation paid, pensions (restricted in certain years), amortized amounts of long-lived assets, and cost of goods sold are deductible items.

The cost of sales is required to be computed in much the same general manner as it is done by accountants. The use of inventories has always been recognized under the Income Tax Acts, and specific recognition of accounting methods (especially in peculiar industries) was granted in 1918.

Prior to 1918, only the historical cost basis for inventories was permitted. Since that time, the basis of "lower of cost or market" has been permitted, because of the pressure exerted by accountants and businessmen to have it included in the law. This basis is inconsistent with the general income tax and accounting emphasis placed upon objective measurement. Market price, base stock or normal inventory, and appreciated cost are not permissible bases.

The provisions for the determination of cost conform closely with those of accounting practice. Special methods, such as the farm price, retail inventory, and apportioned cost methods,

are permitted for certain industries, in accordance with trade and accounting practice.

After the cost of goods available for sale has been determined, there still remains the problem of apportioning part of it against gross revenue. The method favored for tax purposes is actual identification of specific goods sold. The second choice is the "first-in, first-out" method. In 1938, grudging permission was given to allow the "last-in, first-out" method to a very few industries under certain restricted circumstances. This permission was extended to all in 1939, subject to certain restrictions. The moving average method, perhaps the most theoretically correct method, has been denied by the Federal Income Tax provisions. Average methods have not been permitted, except in a very few rare cases.

The chief characteristics of the tax provisions for inventories is their relative permanency and their emphasis on consistency.

There is little with which to find fault in the tax provisions regarding allowable deductions. There are other provisions, regarding non-deductible items, however, which may well be criticized. In 1939, long term capital losses were allowed in full, but short term capital losses were only permitted to offset short term capital gains (although a partial carry-over was permitted).

Certain items are completely non-deductible. Charges to surplus for reserves, dividends declared or paid, and capital expenditures are deductible neither for accounting nor tax purposes. Certain additional items are not deductible for tax purposes.

Under the 1918, 1921, 1936, and 1938 Acts, distributions out of current earnings in spite of a deficit at the start of the year were considered taxable dividends; although, in some cases, such dividends are no more than a repayment of capital.

Deduction provisions generally have followed accounting procedures except that arbitrary limitations and non-deductible items have been specified.

The Federal Income Tax is founded upon a limited net concept of income.

Realized Increase

The use of periodic calculations requires that it be determined within what period gross income and deductions may be said to have occurred. The time at which income is to be recognized and measured is the point of so-called "realization."

The accrual or accumulation basis is definitely recognized in amortization provisions, which have been a part of the income tax system since 1913. The favored method has been a straight line method, although the output basis or others are permitted if they are considered good accounting methods under the existing circumstances. Except for depletion calculations, historical cost has been favored and has always been accepted.

Decreases and increases in market value are not considered to affect depreciation. Repairs expense may be deducted in addition to a depreciation deduction; repairs do not make a depreciation provision unnecessary.

There has been little change in fundamental provisions regarding depreciation, except that the administration of the law has been much more strict since 1934. A heavier burden of proof is now placed on the taxpayer; he may not take advantage of previous depreciation errors; future depreciation is to be computed over the estimated remaining life and may have to be adjusted yearly. In general, accounting methods are paralleled quite closely by the tax provisions.

Depletion provisions have strayed farther from good accounting and business procedure than have most other provisions in the law. In 1913, 1916, and 1917, depletion was required to be computed on cost, but the allowable deduction was arbitrarily restricted. In 1918, discovery value was introduced for mines and oil and gas wells. It was restricted to mines in 1926 and to certain types of mines only, in 1932. In 1926, percentage depletion was permitted for oil and gas wells and in 1932 was extended to the mines excluded from using discovery value depletion.

Both discovery value depletion and percentage depletion deviate widely from the requirements for an acceptable computation of income. They have been justified as a necessary subsidy to a particular type of industry and also because depletion

estimates are necessarily inaccurate. It might be better to put depletion on a cost recovery basis and not to permit the ordinary form of amortization. Depletion on cost has always been permitted for all wasting assets and is required in the case of timber.

Anything which decreases the use life of an asset must be reflected in an increased amortization charge against gross income. Obsolescence falls within this general class. In 1918 it was specifically recognized and, since, has been deductible if it is reasonably predictable and measurable. A deduction for the obsolescence of intangibles such as patents, organization expenses, copyrights, trademarks, and goodwill may not be amortized, because such amortized obsolescence lacks accuracy and objectivity. Except for goodwill and trademarks, these intangibles are subject to depreciation, however.

Difficulties of measurement and the need for objectivity in income determination for tax and accounting use have caused the accrual of gross income and deductions therefrom to be abandoned in some cases, in favor of a given moment of time at which income is to be recognized and measured. Tax and accounting rules are similar in their emphasis on the use of a "closed and completed transaction" as the point for income "realization." So-called "unearned increments" or "decrements" in value are not taken into consideration as income determination factors until assets are disposed of or abandoned.

The sale is usually chosen as the event which marks the point of realization and measurement. That it is not an altogether satisfactory base has been recognized in the special tax and accounting provisions for bad debts, maintenance commitments, average income proposals, short sales, long-term contracts, installment sales, C. O. D. sales, approval sales, cost-plus contracts, production to order arrangements, and "farm price" inventories.

Specific rules have been set up also regarding the point at which income or deductions should be recognized for other than normal operating items.

The trend in the last several years has been to defer the income inclusion to a lessor from leasehold improvements made

by a lessee until the time of disposal of the asset, but to permit it to be spread over the lease if the improvement is required and is equivalent to a rental charge.

The future amortization of unamortized bond discount has frequently been disallowed by the Commissioner but has been upheld by the Board of Tax Appeals. Its status has been summed up in a Treasury Decision issued in 1935. It is deductible at the time bonds are retired, if they are retired for cash. The same rule applies even if the cash is derived from a new stock issue. If the bonds are amortized by an exchange for shares, no deduction may be taken until the shares are sold. If the refunding of bonds is accomplished by the issuance of new bonds, the unamortized discount on the old bonds is to be spread over the term of the new bonds.

Prior to the 1921 Act, only the writeoff method was permitted for bad debts; but since that time, the reserve method may be selected instead.

A fixed moment of time has been specified for the recognition of gain or loss on the following items: repossessions of real estate sold on deferred payment plans; sale of patents, copyrights, goodwill, and installment obligations; judgments; bad debt recoveries; worthless stock; loss of useful value of assets; and dividends receivable.

A class of "tax-free" exchanges has been set up as an exception to the usual rules regarding the recognition of income. It is felt that objective measurement is not possible, that accurate measurement is not easy of accomplishment, or that the burden on the taxpayer should not be made too heavy in the case of such exchanges; and that it would be better to postpone the recognition of income until a later objective event takes place.

This class of exchanges was not included prior to 1918. It has not been modified substantially in recent years, except for a tightening up in places to prevent tax avoidance. Within this general group fall transfers, following involuntary conversion, to controlled corporations, for property of like kind or use, and in conformity with orders of the Securities and Exchange Commission.

The cash, satisfaction, and dissolution bases for income determination have been given scant recognition in either tax or accounting provisions for the calculation of corporation income.

Many of the difficulties encountered in connection with the determination of income for tax or accounting use are caused by the inconsistent use of both an accrual basis and a closed transaction basis for recognizing income. Which is to be used appears to depend upon the certainty of the occurrence of an event and the measurability of the result.

Between Two Points of Time

Fundamentally, income is a long-range concept. It covers a period from the formation of an income producing enterprise to its dissolution. The extremely long life of most enterprises requires that income calculation be broken down into shorter periods for tax and accounting purposes. This breakdown of the long life causes "periodicity" to assume extreme importance and is responsible for most of the problems of accounting and of income calculation. The amortization of assets, the differentiation between capital and revenue expenditures, accruals and deferments, reserves, the differentiation between recurring and non-recurring items, "realization," the carrying over of losses, and the averaging of income are the principal problems of income determination and of accounting, and all are traceable to the introduction of arbitrary short-term periods into the income calculation.

The measurement of income for short periods requires that all related gross income and deduction items be brought into the same arbitrary period. All of the various procedures enumerated above may be considered to be represented by the all-inclusive term of "matching." It is the foundation for the so-called accrual basis of accounting.

"Matching" has always been a part of the modern Federal Income Tax system. The 1909 Act was written on a cash basis but aroused so much opposition that it was enforced on an accrual basis. Beginning with the 1913 Act, accrual accounting has definitely been a part of the Income Tax Law.

The Income Tax idea of accrual methods has not always coincided with that of accountants. Up to about 1925, the legal idea of accruing was tied up with the idea of the existence of a legal claim, of "coming due." In 1926, the Supreme Court recognized that the accounting concept of accrual was superior to the existing legal idea. The Board of Tax Appeals shares this better view now, but, as recently as 1939, was forced to reverse decisions of the Bureau of Internal Revenue in several cases. Apparently the administration by the Bureau is still tied up with the older and less satisfactory idea of the meaning of accrual.

In general, the Federal Income Tax has upheld the idea of strict periodicity in its requirements that adjustments of errors be made through amended returns. It has permitted exceptions from periodicity when necessary in order to obtain a correct reflection of income or when unimportant overlapping items have been handled consistently.

The long-range view of income, rather than periodicity, has been recognized in carry-over provisions for losses. A two-year carry-over was permitted in all years from 1918 to 1928, except 1920. In 1932, the period was reduced to one year and was omitted entirely in 1933. It was reinstated for a very limited use in 1938 and fully reinstated in 1939 to include a two-year period. Unfortunately, the loss to be carried over has always been restricted and has not been the same figure as shown on the tax return.

The Federal Income Tax places its emphasis on periodic income calculations but has overlooked strict periodicity on occasion.

From All Sources

Gross income includes income from all sources, for Federal Income Tax computations. This sweeping generalization must be modified to the extent that certain specific items are tax-exempt.

Business income; leased property income; dividends; some interest; leasehold improvements (to lessor); and profit or loss on non-recurring exchanges, sales, or other asset dispositions

(except for certain tax-free exchanges) are all includible in gross income.

In some years, a certain minimum of income was allowed to go untaxed, but this type of provision is no longer a part of our system.

Dividends included in the purchase price of securities purchased are treated as part of taxable income, when, in fact, they are merely a return of capital.

Prior to the 1921 Act, stock dividends were considered income to the recipient under the statute then in force. From 1921 to 1934, inclusive, share dividends were excluded from income, on the authority of the court decision in *Eisner v. Macomber*. It was felt that this case had been applied too broadly, however, and the Acts of 1936 and 1938 specified that share dividends were to be taxed if they resulted in a change in the interest of the recipient in the corporation.

Gain or loss by a corporation resulting from transactions in its own reacquired shares were to be considered in determining income under the 1916 and 1917 Acts, but not under those of the years from 1918 to 1932, inclusive. They were to be included, under the Acts of 1934, 1936, and 1938, if the transactions were entered into for profit and were substantially equivalent to transactions in shares of another corporation. This same trend has been discernible also in court and accounting opinions.

No special tax treatment has been accorded capital gains and losses of corporations, other than limitation provisions on such losses. Effective for 1940, long term capital losses are deductible in full; short term capital losses are deductible to the extent that there are short term capital gains. (A limited carry-over is also permitted.) Special tax rates do not apply as in the case of individuals. In the years from 1921 including 1934, capital assets were limited to those held over two years. In 1936, this holding period was abolished. In all of the years, classification of capital assets has not included inventories; and in 1938, depreciable assets were also excluded.

Certain other asset inflows are excluded from gross income, because they are considered correctly as capital contributions.

They are the proceeds from the original issuance of shares, donations by shareholders, and forgiveness of debts owed by the corporation to shareholders.

There has been relatively little change in most gross income provisions throughout the years the income tax has been in force, although some of the more questionable provisions have been changed. Artificial exclusion of certain items is the chief objectionable feature of the gross income provisions.

The Federal Income Tax is a tax designed to include all income, but it has been made subject to several exceptions.

Terms of Money

For practical computations, it is necessary that income be expressed in terms of money. Although the medium of exchange is not uniform in different income determination periods, no attempt is made in tax and generally used accounting procedures to adjust the monetary unit to its present purchasing power.

Income Tax Concept of Income

The Federal Income Tax concept of income is: *the modified net increase in assets, recognized as accumulated or at a given moment, from all sources (with some exceptions), measured in terms of money, between two points of time (with some exceptions), excluding non-income adjustments to the store of capital.*

Although there are some provisions and methods used in the income tax system which are objectionable, most of the tax system conforms with accounting practice. Accountants and businessmen are indebted to the Federal Income Tax for the recognition it contains of Accounting. It has, in many cases, caused the adoption in business of correct accounting procedures. In other cases, its deviations from accounting procedures have caused a healthy reexamination of such accounting procedures to take place.

Some of the criticisms directed at the Federal Income Tax are not altogether fair, because, too frequently, perfection is demanded. Businessmen and accountants are often as guilty as is the tax system of inconsistencies and the use of poor income

determination methods. It is rather unfair to demand that tax provisions conform with generally accepted, satisfactory methods when such do not always exist. Many business and accounting procedures result in understatements of income in the interest of conservatism. Often it is difficult to justify such understatements, even for business purposes. There seems to be no reason why such understatements should be permitted for tax purposes, because an income tax should be based on the most accurate income figure obtainable.

Most of the adverse criticisms are, and should be, restricted to other than the theoretical aspects of income determination.[1] Some of these other items which have caused objection to be raised are: unstable policies of the Treasury Department and the statutes, inconsistent rulings on parallel cases, expenses of litigation, complicated statutory provisions, expenses of gathering tax data, conflicting and overlapping requirements of the many governmental units, political expediency, surtaxes on undistributed and excess profits, inclusions in the tax law of penalties and subsidies for non-revenue purposes, rates, administrative methods, and similar non-income determination items.

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[1]These other items are not within the scope of this study and no attempt has been made to judge their validity.

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